



Economic Security Exercise (U)

South Asia Proliferation Project

By Paul D. Taylor
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**Economic Security Exercise
South Asia Proliferation Project
11-12 March 1999**

by

**Paul D. Taylor
Andres Vaart**

Sponsored by the

United States Naval War College

This report contains the main findings of a workshop conducted by the Decision Support Department of the Center for Naval Warfare Studies. The contents of the report reflect the views of the authors and are not necessarily endorsed by the Naval War College or any other department or agency of the United States Government.

PREFACE



VADM Arthur K. Cebrowski, USN
President of the United States Naval War College

The introduction of nuclear weapons to a region raises issues and brings implications far beyond the realm of military operations. This Naval War College Economic Security Exercise, the third in a series, brought together a distinguished group of economic, commercial, financial and academic leaders. Their expertise and the gravity of the issues they encountered combined to make this an unusually important meeting.

By coming to Newport, the participants joined a tradition of games and simulations that the Naval War College has conducted since 1887. We try to think things through *before* the world is shaken by an event. For example, Admiral Nimitz wrote that contingencies had been so carefully examined here that after the start of WW II nothing happened in the Pacific that was strange or unexpected. While always useful, the games have changed in *nature* over time. They evolved from naval games, to joint military games, to games that incorporated our allies in coalitions and took greater account of political factors. Recently we have begun explicit economic security exercises to examine the interaction between economic phenomena and events that used to be considered the exclusive domain of military specialists.

The quantum growth in international commerce and finance during the second half of this century and the access and speed enabled by modern information systems have fundamentally altered the global strategic landscape. The name given this transformation is globalization. But the Navy has been global for more than a century and a continuing forward presence in all the great oceans since World War II. Now the Navy operates on, under and above the sea and in space and cyberspace. Those are also the domains of commerce, finance and communications.

It would be simplistic to say only that trade follows the flag or that the U.S. military exists to make the world safe for American business. Commercial firms and military forces operate within a complex adaptive ecosystem where America's interests have enduring economic *and* security components. Neither business nor the military can work well any more without understanding what was once the virtually exclusive purview of the other. For that reason above all, I commend the insights contained in this report to anyone interested in issues of international economics or national security.

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BACKGROUND

The South Asia Proliferation Project

Following the nuclear tests by India and Pakistan in May 1998, Dr. Lawrence Modisett, Director of the Decision Support Department in the United States Naval War College's Center for Naval Warfare Studies (CNWS), initiated a series of simulations to examine the range of potential consequences of nuclear developments in South Asia. Events, either scheduled or concluded, consider policy implications, potential international responses, economic aspects, and operational factors of these developments. The purpose of this effort is research, to produce useful findings for policymakers and to help our government use its influence to serve long-term U.S. and international interests.

This report concentrates on possible economic and commercial consequences of a conflict in South Asia. These issues were examined during an exercise sponsored by the Naval War College during 11-12 March at the Pell Center for International Relations and Public Policy of Salve Regina University. Ambassador Paul D. Taylor, head of the South Asia Proliferation Project, facilitated the discussion, which included a distinguished panel of participants listed in Appendix A. Preparation of scenarios was the responsibility of Professor Andres Vaart, Advisor to the Dean of the Center for Naval Warfare Studies. Participating in the planning and in the identification of participants and discussion questions was Dr. Peter Dombrowski of the Strategic Research Department of CNWS. Dr. Modisett also contributed to this report.

Exercise Vision and Objectives

Participants in this Economic Security Exercise were asked to consider the possible consequences of a hypothetical crisis. The crisis scenario had been developed in a series of prior events with the Intelligence Community, policy makers, scholars and foreign diplomats. While it was designed to be realistic and plausible, the scenario was meant to be neither a prediction nor even the most likely estimate of future events. Specific military data, including warhead and missile numbers, represented informed assumptions based on publicly available material.

This exercise derived its value from the considered judgement of the participants about how the world would and should react to the events posited by the scenario, which was presented and discussed in three distinct, chronologically ordered moves. In each move, participants' comments were recorded, initially in a networked array using GroupSystems software, which enabled participants to register their comments rapidly and anonymously. Those results were displayed and used to key lengthier oral discussion.

HIGHLIGHTS OF THE PARTICIPANTS' DISCUSSION

The following, in the judgment of the authors, represent the most important observations made by the participants. Additional comments will be viewable in a forthcoming CD-ROM report, which will include material from GroupSystems, comments of participants, and a detailed scenario presentation. Comments are not linked to names of participants but those who participated are identified in Appendix A.

Build-up to War and Conventional Conflict

Perceptions

The presence in India and Pakistan of significant nuclear arsenals affects perceptions about an unfolding conflict, even one that may not look too different from many earlier crises. Although the direct effect on the global economy of a nuclear war of the size depicted in the scenario would most likely be limited, psychological factors will be critical as a crisis unfolds.

Accounting for less than 5 percent of international trade, India and Pakistan are not big players in the international economy. In addition, by 2003 the international financial system may be more robust and less vulnerable to the kind of currency fluctuations likely in a large regional crisis. A conflict between the two that could only be fought with conventional weapons most likely would be dismissed by many, but the presence of nuclear arsenals increases the likelihood that international investors and business interests instead will quickly jump to worst-case conclusions and precipitate an international financial crisis.

Indeed, this factor affected the course of the exercise, as participants consistently declined to key their comments precisely to the scenario's stages. That is, some comments about economic and other consequences of a build-up in tensions reflected concerns about nuclear war well before the armed forces of India and Pakistan had become engaged even in conventional action.

Key Scenario Assumptions

Date: Spring-summer of 2003.

Diplomatic: CTBT, FMCT in effect; both countries joined.

Economic: Global recovery from 1990's crises uneven; rapid cycling of financial and monetary crises experienced; India's recovery from difficulties of the 1990's more advanced than Pakistan's.

India-Pakistan bilateral relations: No gains since February 1999 "bus summit;" no significant increase in trade, or new confidence-building measures. Kashmir dispute unresolved, tension and violence steadily mounting into summer of 2003.

Military: Indian build up continued across range of conventional and strategic systems. Pakistan focused on strategic systems. Both have nuclear-capable delivery systems for warheads (India: 75-100; Pakistan 50-75).

Diplomacy and Controlling Events

The ominous prospect of regional, possibly global, environmental damage and the potential size of a humanitarian crisis would motivate other countries to attempt concerted action.

Participants in the exercise expected U.S. and international efforts to prevent an escalation of a serious situation; failing that, they expected efforts to contend with the potential financial and humanitarian consequences.

Failure of a great power to take leadership would have additional psychological effects, which would be likely to magnify damaging international economic consequences. A call for action would, of course, be easier made than implemented, as was evident in the International Game of this crisis.¹ Failure to attempt to avert the worst consequences would be likely to have domestic political ramifications in some countries if publics held their leaders responsible for failing to prevent a nuclear catastrophe. G-7 financial authorities would be expected to act together to prevent panic in the global financial system.

Non-governmental organizations, which would anticipate, in a post-nuclear relief effort, an unparalleled effort in scale and cost, would contribute to pressure on the international community to spare no effort in seeking a resolution to a conflict before it involved nuclear weapons. NGO's might, for example, become active advocates of a referendum on the status of Kashmir to head off a broader war.

The financial pressure would be an instrument available to the international community to restrain India and Pakistan.

G-7 countries would be likely to tell Indian and Pakistani officials that financial support through the IMF and the World Bank, as well as aid and trade finance, would be threatened by their handling of the crisis. Given their different economic circumstances in this scenario, Pakistan would have been more susceptible than India to this form of suasion. An irony, confirmed in 1998, is that economic sanctions can be *too* powerful; if they destroy the Pakistani economy, they can be counterproductive.

Above all, traders and financiers would expect governments to contain the military situation as well as address the economic and commercial consequences of a conflict.

Scenario Key Events

Phase I (July 2003):

- Crisis triggered by Pakistan after defeat in UN of new Kashmir resolution.
- Anti-Western, anti-Hindu reaction in Pakistan, with massive demonstrations.
- Surge of new violence in Kashmir and Pakistan-inspired violence in India.
- New intensification of gunfire in Kashmir across Line of Control.
- Movement toward borders and heightened alerts by both militaries.

Participant Reactions:

- For some it was "déjà vu all over again."
- Those with economic interests would start hedging, checking on local employees and expatriates, evaluating financial exposure, and reviewing policy options.
- Global financial ramifications expected to be minor, although markets would be nervous, and some players would shift assets to safe havens.
- US expected to lead international effort to prevent escalation.

¹ See CNWS Research Report, "International Game '99, Crisis in South Asia," by Bradd Hayes

The most effective way to calm markets would be to produce a break in the chain of political and military escalation of the crisis to nuclear war.

The world did not panic over the Gulf War. Anything governments could do to remove uncertainty and demonstrate that events were under control would calm markets, but failed attempts could make matters worse. Measures participants suggested included joint US, EU, Russian, and Chinese actions, threats of sanctions, offers of economic incentives, creation of a regional "contact group," and creation of a new UN-sponsored peace keeping operation.

Practical Responses

A build-up of tension would immediately affect commercial activity in the region.

In the initial phases of a crisis, foreign investors and business people would begin to review and possibly activate contingency plans to reduce risks to their investments and personnel. Investors who have seen similar crises before and who are not impressed by nuclear arsenals might act slowly or not at all. As rhetoric gives way to actual conflict, however, international portfolio investors would pull out of South Asia; new foreign direct investment would be postponed, and the credit ratings of India and Pakistan would fall--as they might in other Asian countries, including China.

Short-term capital would be increasingly likely to flee to safe havens, drive up the value of the dollar relative to other currencies, and depress the T-bill rate. Local governments would seek to control outflows of capital, with Pakistan more able to do so than India. With a weak economy, Pakistan might be expected to default on its international debt fairly early in a military crisis, recalling its earlier default on zero coupon bonds.

Oil prices would be likely to rise sharply on the fear of a spread in the conflict to oil-producing countries and add to anxiety over inflation. Japan and Korea would increase their petroleum reserves and shift sourcing toward Indonesia and Malaysia to avoid transiting the Indian Ocean.

Scenario Key Events

Phase II (1-7 August 2003):

- Indian transport with Cabinet members downed by missile fire in Kashmir.
- Wave of terrorist attacks sweeps India; military, government, and religious centers attacked. Pakistan blamed.
- Indian air and artillery attacks occur against targets in Kashmir and north Pakistan suspected of harboring and supporting perpetrators of violence in Kashmir and rest of India.
- Pakistani corps in Punjab launches attack into India, driving 25 km into Indian Punjab. Heavy Indian civilian casualties.

Participant Reactions:

- Commercial interests would rapidly activate strategies for protecting money and other resources.
- International capital markets likely to go into a tailspin, with dollars generally moving out of emerging markets to US safe haven. Pre-weekend timing would intensify effect.
- Government and international financial institutions would be pressed to act.
- As conflict expands an internal humanitarian crisis is also developing. Pressure on U.S. and others to act will increase further.

The governments of India and Pakistan would be expected to seize foreign investments in communications and electrical generation for use in their war effort. This would be unsettling to the investors, but it is permissible under international law if investors are properly compensated.

A panicky reaction to outbreak of war, even only a conventional one, could send financial markets into a tailspin.

If war led to capital flight from emerging markets, those countries especially dependent on foreign capital would have to consider imposing capital controls. Given the experience of 1997-1999, there might be little confidence that international agencies such as the IMF would be able to do very much to address a problem of capital flight in these circumstances. The threat of defaults in markets well beyond South Asia would rise substantially and be felt rapidly in developed countries.

South East Asian markets would be highly sensitive to Chinese perspectives on the crisis and to any sign that Chinese leaders were about to make major changes in financial and monetary policies. With global capital seeking maximum safety, interest rates in developed countries, especially short-term rates, would plummet, and banks and investors would demand orderly intervention to avoid a financial panic.

If this sequence of events were to unfold, the U.S. Government would be expected to work with the Bank of England, the European Central Bank, and international financial institutions to use both positive and negative sanctions to mitigate the worst effects of the crisis. Emergency financial support might be required for certain emerging markets, especially China, Russia, Southeast Asia and East Asia; where capital outflows and possibly an interruption of trade finance would increase financial strains substantially. If any of those countries had existing financial problems, they could be plunged into crisis.

Not all participants agreed with all aspects of this scenario, and some held that it was still possible, even in the worst case, to absorb the shock of war in South Asia. Key determinants include timing—when in the global business cycle the events occur—the status of China's economy and monetary system, and the state of recovery in Japan, Brazil, and Russia.

Likely US steps in the crisis

Intensive diplomatic efforts would be undertaken with India and Pakistan and at the United Nations to forestall war. Particular attention would be paid to Russia and China to get them to use their influence with India and Pakistan to urge restraint.

Preparations for a Noncombatant Evacuation Operation (NEO) would begin, and forces would be moved to the scene for potential use in containing the crisis.

Given the inland location of the capitals, evacuation of U.S. nationals from India and Pakistan would pose a major challenge.

Naval assets would be used to obtain the best available picture of the evolving situation for the CINCs and Washington leadership.

Washington agencies may differ on whether to assign peacekeeping troops to an area that could enter a nuclear war. Other military options, including preemption, would be difficult politically.

Nuclear War and After Effects

Post Nuclear Relief and Reconstruction

The displacement of more citizens from their homes than at any time since World War II—likely in this scenario—would outstrip the capacity of relief agencies to cope.

Internally Displaced Persons would be likely to number in the tens of millions, with most moving from North to South. Movement on that scale would create demand for massive international assistance, but it might also create conditions that would prompt civil war between groups of citizens, allied by ethnicity and religion, vying to control precious resources. General panic would prompt large numbers of people, especially the most advantaged, to leave both countries. The destabilizing effects of refugee movements could be more important economically than the impact of capital flows.

Reconstruction needs would require an international donors' conference to mobilize resources and coordinate efforts.

Even a modest program for Pakistan could overwhelm the resources of the Asian Development Bank. The cost of reconstruction could run from \$5 billion to as much as one hundred times that amount. A conference would be needed, as in the case of Bosnia, to arrange burdensharing and to specify the role of the IMF, the World Bank, and governments and to seek ways of assuring that the peace would be maintained. The international community would look especially to Islamic governments for financial support to Pakistani reconstruction.

Humanitarian needs would require billions of dollars of food aid and more for reconstruction.

In addition to the immediate war casualties, millions would die from nuclear illness, population displacement, exposure and famine. Humanitarian concerns for Indians

Scenario Key Events

Phase III (7-9 August 2003):

- Indian counterattack in North and troop movements in South prompt Pakistan to fear dismemberment and to launch tactical nuclear strike on Indian forces in Thar desert and city of Jodhpur.
- India responds with 12 nuclear strikes on nuclear and missile installations, most in North and Central Pakistan.
- Pakistani Government rendered inoperative; remaining authorities unilaterally cease military action.
- Fifteen million casualties estimated, including 1 million-2 million deaths. Uncountable number in North displaced.

Participant Reactions:

- Immediate focus on humanitarian issues, complicated by likely chaotic situation in Pakistan and uncertainty over control of military and residual nuclear weapons.
- Financial chaos and hoarding of goods likely in both countries.
- Continued punishment of emerging markets likely; possible global rise in commodity prices. Otherwise global impact dependent on other variables, especially sustainability of peace.
- Depending on climatic conditions, severe shortages of food, potable water. If more than 10 million were affected, world system could not respond to save all.
- As conflict expands, an internal humanitarian crisis is also developing. Pressure on U.S. and others to act will increase further.
- New global power balance seen.

and Pakistanis affected by the nuclear exchange, reinforced by concerns of large emigration flows out of the two countries would generate an effort to provide as much assistance as possible.

If the devastation were such that losses in food production left only 10 million people totally dependent on food aid, the world would be unable to provide it without serious rationing. Cost would be hard to measure, but it would depend on how much the purchase affected food prices. Medical and transport costs would add another \$1 billion. These sums are beyond the capacity of the donor community without special appropriations.

The condition of water supplies would be a crucial consideration; if weather conditions at the time of the nuclear explosions rendered water unpotable and dangerous, a new series of devastating complications would result. NGOs would be unable to deal with most of these.

International aid agencies and organizations would find dealing with a nuclear catastrophe far more complex and dangerous than feeding hungry Somalis or Rwandans. Aside from the contamination risks, triage is harder than relief. Relief efforts in Pakistan would be complicated by the absence of a viable national government.

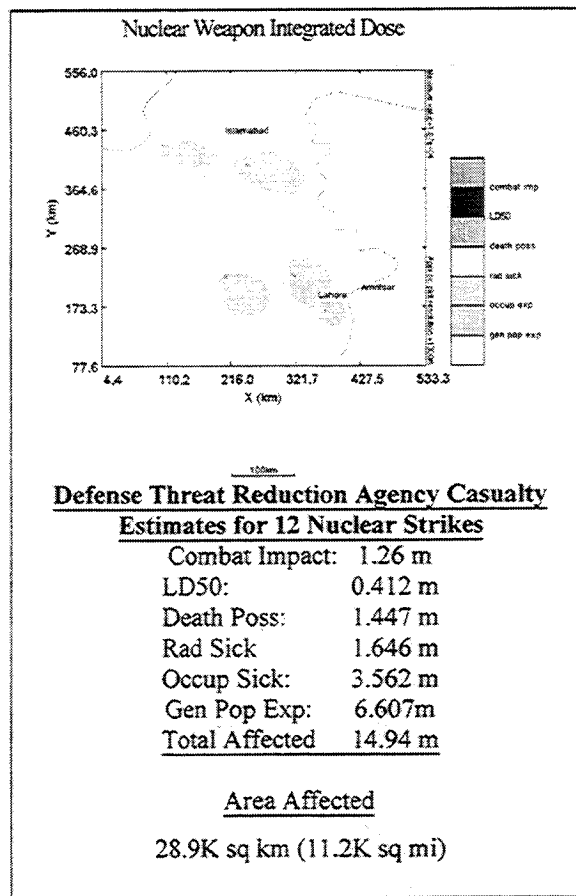
The prospect that countless Indian and Pakistani refugees might seek homes in other countries would lead to creation of stronger immigration barriers.

Countries neighboring India and Pakistan would likely try to resist the entry of many refugees. The West might benefit from the exodus of human capital from South Asia, but this exodus would diminish the ability of the economies of both countries to recover.

The Global Picture the Day After

Pakistan would be virtually eliminated as a functioning economy and viable democracy

The kind of nuclear strikes envisaged in this scenario would most likely have left Pakistan without a functioning government. Presumably some form of martial law would emerge in Pakistan; similar measures might be required in India. Massive amounts of capital would be needed to restore essential services and to care for the wounded and sick in Pakistan. Islamabad would be virtually dependent on charity, as its capacity to borrow would be badly diminished.



Pakistan could require years, even decades, to recover economically. Islamabad and to a lesser extent, India, would be much less able to cope with natural disasters—such as earthquakes and monsoons—for long after the nuclear exchange.

Pakistan's weakness could prompt India to consider enlarging its territory or cause elements in Afghanistan or Iran to seek to annex parts of Pakistan.

Even if India emerged largely unaffected by direct war damage, adverse effects on its economy could be significant, as foreign investors took their chips off the table.

Under the exercise scenario, India did not suffer large destruction of infrastructure or other property. Nonetheless, investor interest in South Asia would be obliterated, at least in the short-term. U.S. and other foreign companies would scramble to remove expatriate personnel and to reassess their options in the face of large population dislocations, flight abroad of elites, radiation fears, and the outlook for reconstruction. The few people willing to leave their money in the subcontinent, however, might be richly rewarded, because capital would be scarce in both India and Pakistan.

Emerging markets might be hard hit as investors sought safety and moved assets to stronger markets in the United States and Europe.

The extent of adverse effects would be proportional to confidence in the durability of the cease-fire in South Asia and the geographic proximity of markets to the war zone. Latin American markets could actually benefit.

The international community would wish to stabilize weakened economies in the region, even if it moved to punish India.

Help for weakened economies could stress global liquidity availabilities. Stabilization of countries neighboring the region, such as Russia and Thailand, could require \$100 billion to prevent financial contagion from the effects of the war.

The United States, the European Union, and Japan would push for trade and financial sanctions against India and demand that India pay reparations to Pakistan. Whether the "winner" in this scenario would pay reparations was not clear. Foreign powers might press for nuclear disarmament in South Asia, but the levers of influence on India would be weak.

Players Perspectives on the End Game

The United States, China, Russia, and Europe most likely would press India to accept the cease-fire offered in the scenario and seek means to reinforce it.

The international community would favor the elimination of remaining nuclear weapons in the possession of India and Pakistan.

Pakistan's dire need for humanitarian relief and reconstruction aid gives it incentives to deal away any remaining nuclear arms, either in disarmament negotiations or through a buyout, as occurred in states of the former Soviet Union. The same leverage would not be available to influence a less-injured India.

The international community might opt for trade and targeted financial sanctions against India to support denuclearization.

Prices of certain commodities, especially foods, would be boosted and could trigger a global recession.

Global food markets would get a shot in the arm after years of low prices as a result of the disruption of food production in the Sub-Continent and the increased need for relief supplies. Longer-term effects would depend on the extent of nuclear fallout in South Asia and the reaction of global consumers. Concerns about environmental damage and the dangers to world food stocks could create a price premium for countries far from the action.

Increased interest in defensive measures would drive demand for missile defense systems and nuclear clean up technology.

A perception that this event had made nuclear war more thinkable could heighten anxiety in Japan, South Korea, Europe, and the United States about a nuclear attack on their territories from North Korea, Iran or Iraq.

Perceptions of the durability of post-nuclear peace arrangements and the environmental consequences will have an economic impact.

International participation in forging a peace, including the introduction of international peacekeeping forces presumably would be welcomed by potential investors interested in participating in recovery efforts. Post-war terrorism and communal violence would darken the climate for international investment.

Little long-term recovery assistance would be forthcoming before the environmental questions were clarified, including questions about water supplies, rivers and ground water.

An early question in the West would be whether or not apathy would replace initial public horror as people realized they were not going to be affected directly by fallout.

Requirements for nuclear cleanup would focus attention on the capabilities of U.S. military and civilian agencies.

The U.S. armed forces would be seen as the best prepared organizations in the world for dealing with issues of consequence management ranging from nuclear decontamination to civil affairs. Their efforts would have to be coordinated with complementary work by civilian agencies and non-governmental organizations from the United States and other countries.

The Blame Game

The international community would be pulled by contradictory impulses: to punish India and Pakistan for their nuclear transgressions or to respond sympathetically to a humanitarian disaster.

The United States, the EU, Japan, and China most likely would urge economic sanctions against India and demand that India pay reparations to support the reconstruction of

Pakistan. Whether India, as the perceived “winner” in this event, could be persuaded to help Pakistan is not clear.

The war would alter the geopolitical balance of the Sub-Continent and beyond.

The participants expected India to conclude that it had consolidated its political dominance in the region and to accelerate its quest for respect as a global geostrategic player, including a permanent seat on the Security Council—an initiative the Permanent Five members would resist. A new, tense relationship based on new nuclear calculations would be certain to emerge between China and India.

In the Middle East, violence could be expected against Indian workers in the region; Western concerns would probably also be targeted, because of Western failure to prevent the Indian action. In any free-for-all of violence, Israeli assets would also be targeted.

The non-proliferation regime would be buffeted by contradictory conclusions about what the nuclear exchange had demonstrated.

Some would conclude it was a dead letter, with some Muslim countries anxious to get their own bombs. North Korea might conclude that if India could “win” a nuclear war by employing a dozen weapons it could reunite Korea on its terms. Others would expect a redoubled effort to find mechanisms to prevent a further nuclear exchange between India and Pakistan and elsewhere in the world. Conflict resolution and reconciliation would gain greater salience in strategic planning.

This scenario could have profound political consequences for a U.S. administration.

As the foreign country most engaged in South Asian nuclear issues since 1998, the United States would suffer a severe loss of international prestige if U.S. handling of the crisis were perceived to be deficient. This could cost a President reelection. European leaders might conclude that the world would be safer if they had more voice in its management. Muslim countries would question the ability of the United States to protect their interests. Japan could question its dependence on U.S. military support. Domestically, there would be a broad drive for reallocation of resources toward defense and accelerated deployment of a national missile defense system. A sense that the United States and the international system had failed to maintain the peace would strengthen isolationist impulses. Some might conclude, though, that the outcome proved the need for the United States to work even harder to police the globe.

US Policy Options

Participants identified a number of steps that the USG could begin taking now to prevent or manage a future conflict in South Asia:

- Develop and deploy credible missile defense technology.
- Invest in rebuilding intelligence capability.
- Develop multicultural diplomatic expertise.
- Analyze various conflict scenarios and their consequences to provide sobering realities to decision-makers who might opt for violent approaches.

- Facilitate a “Track II” set of non-official and semi-official discussions between India and Pakistan analogous to the Pugwash conferences that helped U.S.-USSR arms control efforts during the Cold War.
- Encourage improvement in the management of strategic weapons in India and Pakistan to minimize the chances of accidents.
- Jump-start development of confidence building measures and crisis management measures between India and Pakistan to prevent a “use ‘em or lose ‘em” mentality.
- Invest the time and resources to find a solution to the Kashmir dispute similar to the investments in the Middle East peace process or the crisis in the Balkans.
- Bring India into a wider discussion of security across Asia.
- Invest more energy and funding to convince Pakistan and India to liberalize and modernize their economies to give them more of a stake in peace by 2003.
- Enhance commercial, investor and financial engagement with India and Pakistan.

APPENDIX A

Participants in the Economic Security Exercise

Beckman, USN, Capt. C. Barry	Strategy and Plans, J55	US Pacific Command Camp H.N. Smith, Hawaii
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